Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:[redacted]:1:POSTF151907-01
[redacted]

date: January 23, 2002

to: [redacted], Revenue Agent
[redacted]
[redacted]
Stop [redacted]

from: Associate Area Counsel, LMSB [redacted]
subject: [redacted]

Bonus vs. Disguised Dividend

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

DISCUSSION

This memorandum responds to your request for assistance dated November 15, 2002. Your inquiry was referred to this office from Industry Counsel Vallie Brooks. We have coordinated our response with the Industry Counsel. This memorandum should not be cited as precedent.

Facts

The following facts are as set forth in revenue agent's memorandum supplemented by the taxpayer's responses to the revenue agent's information document requests.

[redacted] ("[redacted]") provides physician and outpatient healthcare services. For the [redacted] taxable year, [redacted] deducted $[redacted] as a general supplies expense. Upon examination of the [redacted] Federal Income Tax Return, [redacted] provided that the $[redacted] was really for bonuses paid to physicians during [redacted] taxable year.

Prior to [redacted], [redacted] was a personal service corporation owned and operated by shareholder-physicians. [redacted]'s employees consisted of physicians, corporate officers, clerical and support staff. Each physician had an employment contract with [redacted]. Physician salaries were determined by their full productivity as defined in the employment contract and additional compensation as [redacted] "deemed appropriate".

On [redacted], [redacted] substantially sold all of its assets and liabilities to [redacted] L.P. and [redacted], Inc. (collectively referred to as "[redacted]"). The total acquisition cost to be paid by [redacted] in cash and stock was $[redacted]. Also as part of the sales agreement, [redacted] received additional income on the sale of land and a building that [redacted] required [redacted] to sell. In conjunction with the sale, [redacted] agreed to provide comprehensive management and support services to [redacted] for a base and cost management fee.

[redacted]'s Board of Directors ("Board") authorized the sale and affiliation with [redacted]. Relevant portions of the Board's resolutions regarding [redacted]'s distributions to shareholder-physicians' are as follows:

Resolved: [redacted] was to partially redeem the stock of the shareholders, except for stock with a face value of $[redacted].

Resolved: The physicians that signed the employment agreement for continuing service after the asset sale were to receive a signing bonus not to exceed $[redacted].

Resolved: In recognition of past services which were compensated at a reduced rate in order to support the capital and growth needs of [redacted] each employee physician should receive a one-time bonus upon the closing of Agreements with [redacted] in an amount not to exceed $[redacted] (*Note:* [redacted] *already has an accrued termination pay liability account which is owed to doctors that took lower salaries when the corporation was becoming established. This liability is being paid out over five years.)*

Resolved: In recognition of their continued contribution, each employee physician should receive an annual bonus for each of the first six years after executing the Employment Agreement during which that physician continues in employment with [redacted], which bonus shall not exceed $[redacted] during the first year and a fixed amount not to exceed $[redacted] during each of the subsequent five years with a possible adjustment in year three if [redacted] is required to pay the make-up payment on its stock and in year six based on allocation of amounts remaining on the land partnership notes payable. (This statement indicates that the amounts due to employee physicians on the land notes would be converted to salaries.

Of the [redacted] shareholder-physicians, [redacted] redeemed the interests of [redacted] shareholder-physicians and allocated $[redacted] as bonuses to the [redacted] shareholder-physicians who executed new employment contracts with [redacted] and continued service after the [redacted] asset sale. Included in the $[redacted] distribution were payments to [redacted] corporate officers, who were shareholders but not physicians, totaling $[redacted].

No bonuses were paid to the [redacted] shareholder-physicians who ended their employment

agreements. Instead, [redacted] redeemed their stock ownership interest, provided each a buy out package for approximately $[redacted] and claimed these distributions as either severance pay or dividends for the [redacted] tax year. No bonuses were paid to corporate officers who did not own shares in [redacted], clerical or support staff.

The $[redacted] allocated as bonuses entirely stem from the proceeds of the [redacted] asset sale. The amount was reduced by the amount included on recipient's Forms W-2 for bonuses of $[redacted], leaving a balance of $[redacted] in the Physician bonus account. The Board's resolutions provide for a $[redacted] maximum ($[redacted] total) signing bonus to be paid to shareholder-physicians who continue service after the [redacted] asset sale. The amount actually paid as bonuses ($[redacted]) exceeded this signing bonus maximum by $[redacted].

The amounts allocated as bonuses correlate directly to the ownership percentage of shareholder-physicians who continued employment with [redacted] after the [redacted] asset sale. [redacted] provided no records to establish the nature or extent of the services rendered by shareholder-physicians, the basis of the apportionment, value of their services or the reasonableness of the purported bonus. The amount of distributions paid to shareholder-physicians was not in fact compensation, but merely a distribution of fixed percentage of the net profits realized from the [redacted] asset sale that had no relation to the services rendered.

[redacted] has never declared or paid dividends and did not intend to declare dividends in [redacted]. At the end of [redacted], [redacted] had no retained earnings. The bonuses have their origin and arose directly from the [redacted] asset sale. [redacted] was not the employer of the physicians after the sale. The employment contracts remained with [redacted]. On its Federal Income Tax Return for the [redacted] tax year, [redacted] deducted $[redacted] as a general supplies expense. When the Revenue Agent inquired about this expense, [redacted] revealed that the expense was actually for bonuses paid during the year. By accelerating the bonuses to the [redacted] taxable year, [redacted] absorbed all profits from the [redacted] asset sale and created a $[redacted] net operating loss available for carry-back for the tax years [redacted] and [redacted] and carry-forward to [redacted] and [redacted].

Issue:

1. Is [redacted] entitled to deduct $[redacted] as a general supplies expense for amounts paid to shareholders under Code Section 162(a) for the [redacted] tax year?

2. Do the facts and circumstances that you have developed support the application of the accuracy-related penalty pursuant to Section 6662 of the Code for the [redacted] tax year?

Conclusion:

1. [redacted] is not entitled to deduct $[redacted] as a general supplies expense for amounts paid to shareholders under Code Section 162(a) for the [redacted] tax year.

2. The facts and circumstances that you have developed support the application of the accuracy-related penalty pursuant to Section 6662 of the Code for the [redacted] tax year.

Discussion

1. **[redacted] is not entitled to deduct $[redacted] as a general supplies expense for amounts paid to shareholders under Code Section 162(a) for the [redacted] tax year.**

[redacted] failed to establish that $[redacted] deducted as an expense was for general supplies for the [redacted] tax year. [redacted] provided that $[redacted] deducted as a general supplies expense was really for bonuses paid to its shareholders. The purported bonuses paid left [redacted] with a $[redacted] loss for the [redacted] tax year. [redacted] filed amended returns to claim refunds by carrying the [redacted] loss to the [redacted], [redacted], [redacted] and [redacted] tax years.

Section 162(a) allows a deduction for all the ordinary and necessary expenses paid in carrying on a trade or business, including a reasonable allowance for salaries, or other compensation, for personal services actually rendered. Section 1.162-9 provides in pertinent part:

> "Bonuses to employees will constitute allowable deductions from gross income **when such payments are made in good faith and as additional compensation for the services actually rendered by the employees,** provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income."

The determination of whether the payments were made with the intent to compensate for services is a factual question to be decided on the basis of the particular facts and circumstances of the case. Paula Construction Company v. Commissioner, 58 T.C. 1055, 1058 (1972). Because the shareholder physicians, with respect to whom the deductions are claimed, were in complete control of petitioner's affairs, close scrutiny must be given to the relevant facts to determine whether so-called compensation is not in reality a distribution of profits in a manner calculated to avoid payment of income and excess profits taxes. Botany Worsted Mills v. United States, 278 U.S. 282 (1929); Lowland v. Commissioner, 244 F.2d 450 (1957).

[redacted] did not treat the payments as bonuses. [redacted] did not claim the payments as bonuses or wages during the year in issue, but rather claimed the amounts as a general supplies

expense, even though it knew that such amounts were not expended for general supplies. In addition, the payments were included in employees' W-2 forms, and Federal income taxes and social security taxes were withheld from such payments.

The bonuses from the proceeds of the sale were only paid to [redacted]'s shareholders, the majority of who are physicians, and not to any of its other employees. Of the [redacted] shareholder physicians that contributed additional $[redacted] Paid-In Capital, [redacted] received those funds incident to the sale, [redacted] physician, who decided not to remain with [redacted], received the $[redacted] plus $[redacted] for his stock (plus a buy-out package negotiated later, for $[redacted] as severance pay, in the fiscal year). [redacted] other physicians ended their employment agreements [redacted] & [redacted]. Each received a buy-out of $[redacted]. [redacted]'s first response received on this distribution was that "the payment was a complete redemption of their shareholder interests." [redacted] later modified their response and provided that their stock was redeemed for $[redacted] each. For recognition of past services, $[redacted] was to be paid to each physician, $[redacted] in the initial year, the balance to be paid over the next five years. No amount was included on the physician's W-2s for these payments. No 1099 was issued to the physicians as [redacted] believed the payment was effectively a redemption. The [redacted] physicians were to receive an amount similar to the shareholder physicians that remained with [redacted] and signed the new employment contracts. A system of paying bonuses only to shareholders smacks of a distribution of profits. Nor-Cal Adjusters v. Commissioner, T.C. Memo 1971-200, aff'g, 503 F.2d. 359 (9th Cir. 1974).

A compensation payment intended to make up for earlier years will be deductible only if the corporation documents:

- The amount of the underpayment in prior years; and
- That the current payment is intended as compensation for prior services.

In this case the Board determined the physicians were entitled to $[redacted] for past services. This was done pro rata based on stock holding, with no consideration of length of service, amount of time spent on the job, additional activities performed for the clinic, etc. The $[redacted] is in addition to the termination pay accrual. The Court's opinion in Mad Auto Wrecking provides that an "employer may deduct compensation paid to an employee in a year although the employee performed the work in a prior year. In order to do so, the employer must show: (1) That the employer intended to compensate the employee for past under-compensation, and (2) the amount of the under-compensation." Mad AutoWrecking, T.C. Memo 1959-94.

[redacted] has failed to establish the nature or extent of services rendered by the shareholder-physicians. The Board determined that bonuses were to be paid to the physicians that signed on with [redacted]. No consideration was given to a physician's specialty or income generated. These

amounts are not based on services for the shareholder's specialty , on the number of patients, or the to the stockholdings of the recipients. The purported bonuses paid by [redacted] as additional compensation were not for the services rendered by the shareholder-physicians

The purported bonuses have their origin and arose directly from the sale of assets to [redacted]. The bonus payments authorized by [redacted] correlates directly to the amount of cash and stock received from [redacted]. By accelerating the bonuses to the year of sale, [redacted] absorbed all profits from the sale and created a net operating loss available for carry-back for the tax years [redacted] and [redacted] and carry-forward to [redacted] and [redacted].

Only shareholder-physicians that executed employment agreements with [redacted] and [redacted] corporate officers who were also shareholders received a bonus. The amounts paid as bonuses by [redacted] to its shareholders for future services, had no relation to the measure of their services and absorbed all the profits from the sale to [redacted]. The amounts paid as bonuses are not in reality payment for "services rendered", and cannot be regarded as "ordinary and necessary expenses" within the meaning of Section 162(a). Botany Worsted Mills v. United States, 278 U.S. 282 (1929).

The following factors indicate that payments to shareholder-employees are disguised dividend distributions rather than payment for services rendered:

1. bonuses were in exact proportion to stockholdings;

2. payments were in lump sums rather than as the services were rendered;

3. there was a complete absence of formal dividend distributions by an expanding corporation;

4. the system of bonuses was completely unstructured, having no relation to services performed;

5. the company's negligible taxable income was an indication that the bonus system was based on funds available rather than on services rendered; and

6. bonus payments were made only to the stockholders in proportion to their stockholdings, and not to other employees.

See, e.g., O.S.C. & Associates, Inc. v. Commissioner, 187 F.3d 1116,1120 (9th Cir. 1999); Nor-Cal Adjusters v. Commissioner, 503 F.2d 359, 361-362 (9th Cir. 1974), aff'g, T.C. Memo 1971-200; Wagner Construction, Inc. v. Commissioner, T.C. Memo 2001-160.

The amounts were distributed in exact proportion to the stockholdings of the recipients. If the bonuses were to be based on the effort expended or services rendered, then each shareholder employee's contingent salary would presumably have been a more appropriate gauge of what he deserved. In fact, the bonuses were quite disproportionate to the contingent salaries received by each

shareholder employee. Paying the bonuses in exact ratio to stockholdings supports the finding that the purported bonuses were in substance a dividend rather compensation for services.

[redacted] has never declared or paid dividends and did not intend to declare dividends in [redacted]. At the end of [redacted], taxpayer had retained earnings of $[redacted] on the cash method balance sheet for tax purposes. While no single element is conclusive in determining whether alleged compensation was in substance a distribution of earnings, [redacted]'s history of never having declared or paid dividends is significant. Prudent businessmen will not long pursue an endeavor which yields no return on invested capital. Charles McCandless Tile Service v. United States, 422 F.2d 1336 (Ct. Cl. 1970); Exacto Spring Corporation v. Commissioner, 196 F.3d 833 (7th Cir. 1999) rev'g, T.C. Memo 1998-220; Elliots, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983).

[redacted] computed bonuses and the Board declared the bonuses based on the availability of proceeds from the [redacted] asset sale. The first bonus authorized and paid on [redacted] correlates directly to the amount of stock received from [redacted]. The shareholder physicians received stock, and only a small amount of cash for the first bonus. The cash received for the second declared bonus correlates to the cash received from the [redacted] asset sale. The third distribution, an advance payment on the first year service, paid on [redacted], per the [redacted] minutes was "the [redacted] day payout" following the affiliation with [redacted] The major cause for the decrease in expected amount was the unexpected closing cost on the real estate and the employer's share of FICA taxes. The schedules related to the Bonus Earnings Receivable provided by [redacted] include computations related only to the shareholders and shareholder doctors. The Funds distributed had no relation to services performed by shareholder physicians.

[redacted] taxable income has remained constant. They are a personal service corporation and chose, in the past, to pay taxes rather than pay bonuses or dividends in order to maintain the cash for operations. Per the [redacted] minutes, it was projected based on the operating budget for [redacted], that the $[redacted] was equivalent to the former profit and income taxes. It is apparent that the bonus payments, deducted as general supplies, were based on available cash and stock from the sale rather than on services rendered in an effort to avoid any tax liability. The excessive compensation resulted in a net operating loss carry-back that would generate an additional $[redacted] deduction for [redacted].

In this case, all the factors indicate that amounts paid as bonuses were disguised dividends. The Supreme Court of the United States has repeatedly observed that "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not." Higgins v. Smith, 308

U.S. 473, 477 (1940); Old Mission Portland Cement Co. v. Helvering, 293 U. S. 289, 293 (1934); Gregory v. Helvering, 293 U.S. 465, 469 (1935).

2. The facts and circumstances that you have developed support the application of the accuracy-related penalty pursuant to Section 6662 of the Code for the [redacted] tax year.

Section 6662 provides for an accuracy-related penalty (the accuracy-related penalty) in the amount of 20 percent of the portion of any underpayment attributable to, among other things, negligence or intentional disregard of rules or regulations (without distinction, negligence), any substantial understatement of income tax, or any substantial valuation misstatement. Negligence has been defined as lack of due care or failure to do what a reasonable and prudent person would do under like circumstances. See, e.g., Hofstetter v. Commissioner, 98 T.C. 695, 704 (1992). Section 6664(c)(1) provides that the accuracy-related penalty shall not be imposed with respect to any portion of an underpayment if it is shown that the taxpayer acted in good faith and that there was reasonable cause for the underpayment. The determination of whether a taxpayer acted in good faith and with reasonable cause is made on a case-by-case basis, taking into account all pertinent facts and circumstances. "Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of * * * law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer." Sec. 1.6664- 4(b)(1), Income Tax Regs.Petitioner bears the burden of proving facts showing good faith and reasonable cause. T.C. Rule 142(a).

The same factors that resulted in our evaluation that [redacted] is not entitled to deduct $[redacted] as a general supplies expense for amounts paid to shareholders for the [redacted] tax year lead us to support the application of the section 6662(a) penalty. [redacted] did not treat the payments as bonuses. [redacted] did not claim the payments as bonuses or wages during the year in issue, but rather claimed the amounts as a general supplies expense, even though it knew that such amounts were not expended for general supplies. Further, bonuses paid by [redacted] as additional compensation were not for the services actually rendered by the shareholder-employees. We note that you have provided [redacted] with a Form 5701 regarding the application of the 6662(a) penalty. We further note that you have advised us that [redacted] will provide a response to your Form 5701. This response should contain any defenses to the application of the penalty. Therefore, we cannot yet evaluate the strengths of any such defenses.

Post Review

With respect to Issue No. 1, we are submitting this advisory opinion for post review and anticipate a 10-day response from the National Office. As you know, the response can

supplement, modify and/or reject the advice contained herein. **Accordingly, please take no action on the advice contained herein with respect to Issue No. 1, until such National Office response is received by the undersigned. You will be promptly notified of any exceptions or modifications recommended to the advice contained herein.**

In the interim, should you have any questions regarding this memorandum or our recommendations, please contact the undersigned at ([redacted]) [redacted], ext. 332.

[redacted]
Associate Area Counsel
(Large and Mid-Size Business)

By: _____
[redacted]
Attorney